Technology

Time to Ride the Automotive Market Recovery

OVERWEIGHT
↑

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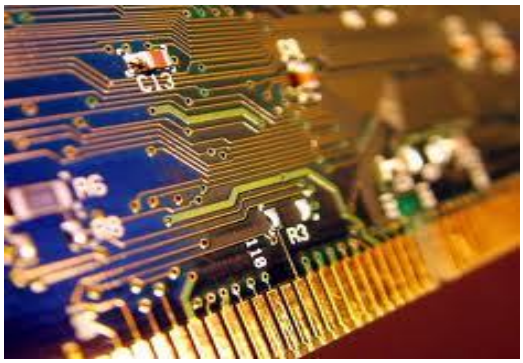
In 3Q19, despite trade-war-induced uncertainties, we reckon that the outlook for the technology sector is turning slightly more encouraging. We are seeing possible signs of recovery in major automotive markets like China and the Europe in 2H19. And, the long-term prospects of automotive-centric technology players are also promising due to rising semiconductor content in vehicles. To capitalise on the automotive market recovery and its exciting long-term prospects, we recommend taking positions in D&O and KESM given their automotive-focused portfolio (>90% and >80% of revenue, respectively). Meanwhile, the outlook for the smartphone industry appears fairly stable as we expect a decent functionality upgrade in the upcoming Apple iPhone models (to be launched in 3Q19). In the EMS space, prospects for SKPRES remain promising as it continues to see contracts driven by its major customers' shift to newer models, while PIE is expected to benefit from the relocation of manufacturing facilities from China. All-in, with a potential turn of the tide in the technology sector (especially in the automotive segment), while valuations have also become more palatable, we upgrade the technology sector from NEUTRAL to OVERWEIGHT. We select (i) D&O (OP, TP: RM0.675) and (ii) KESM (OP, TP: RM8.70) as our top picks, both prime proxies for the automotive market recovery.

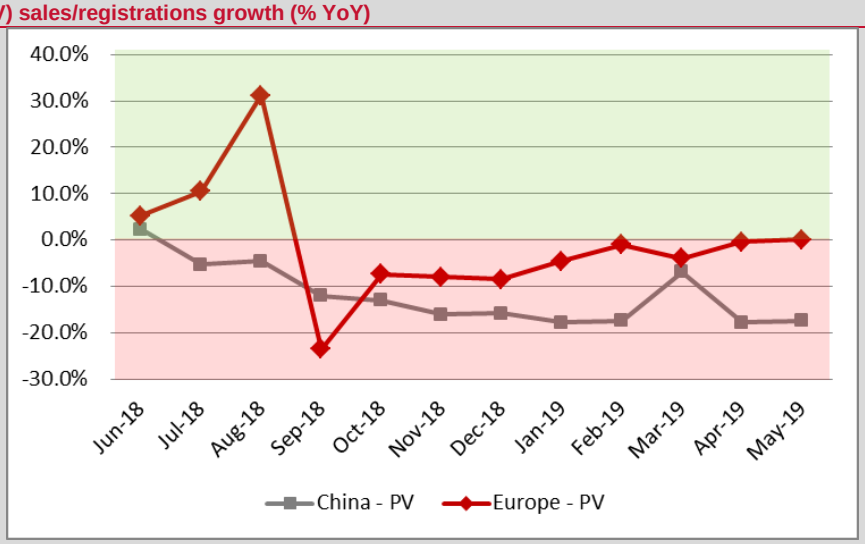


Showing positive signs. In 3Q19, though some uncertainty remains amidst the trade war, we reckon that the outlook for the technology sector is turning slightly more encouraging, while valuations have also become more palatable. As such, we are upgrading the technology sector from NEUTRAL to OVERWEIGHT, mainly premised on a possible recovery in major automotive markets, while the smartphone industry outlook appears fairly stable.

Worst could be over for the automotive market. We are seeing possible signs of recovery in major automotive markets like China and the Europe in 2H19. In China, passenger vehicle sales have been declining for 11 straight months since tariffs were imposed on American automobiles in April 2018. Additionally, consumers have likely been deferring car purchases in anticipation of new VI emission standards (to be implemented in July 2019). Going into 2H19, with a series of policies like tax-cut for rural consumers, fees reduction and lifting of licence plates quota in Guangzhou and Shenzen, passenger vehicle sales are likely to return to the growth trajectory. Meanwhile, in the Europe, passenger car registrations have already turned slightly positive (+0.1% YoY) after 8 consecutive months of YoY declines, as the adverse effect of the Worldwide Light Vehicles Test Procedure (WLTP; introduced in September 2018) subsides. For the long term, prospects of the automotive-centric semiconductor players are also promising. Market research firm IC Insights forecasts automotive semiconductor market to be the strongest end-market for electronic chips through 2021, with 5-year CAGR of 5.4%, underpinned by: (i) rising demand for electronic systems in vehicles to power autonomous driving, vehicle-to-vehicle and vehicle-to-infrastructure communications; as well as (ii) on-board safety, convenience and environmental features.

D&O and KESM are prime proxies for the automotive market recovery. To capitalise on the automotive market recovery and its exciting long-term prospects, we recommend taking positions in D&O (OP; TP: RM0.675) and KESM (OP; TP: RM8.70) given their automotive-centric portfolio (>90% and >80% of revenue, respectively). Apart from the duo, our outsourced semiconductor assembly and test (OSAT) players (MPI and Unisem) have also been realigning their portfolios in the past 1-2 years with capex skewing towards the automotive segment (e.g. sensors packaging, advanced vehicle safety systems). MPI (OP; TP: RM12.10) has shown increased contribution from automotive sensor-related packaging products with 32% share in 1QCY19 vs. 24-25% in FY17, and it targets to grow this to 50% in 2-3 years. For UNISEM (UP; TP: RM2.15), its contribution from the automotive segment has been stable at 15-18% in the past few years, but is set to grow larger going forward given its ties with one of the key players in tyre pressure monitoring system (TPMS). TPMS should see increasing market penetration over the next few years as China has made it compulsory for all new M1 vehicles to carry TPMS by 2019. However, we are maintaining our UNDERPERFORM call on UNISEM on valuation grounds.

Passenger vehicle (PV) sales/registrations growth (% YoY)



Source: CAAM, ACEA

Trade war tension eased, not vanished. Last week, the US President Donald Trump announced that the US would lift the ban on Huawei as part of a temporary trade truce. While the headline is positive, we are mindful that the underlying problems are not entirely solved – Trump had only said that the US will not impose new tariffs "for the time being" but existing tariffs remain, and trade negotiations would continue. Additionally, while Trump allows US companies to resume selling equipment to Huawei, the decision on whether to take Huawei off the Commerce Department's entity list has yet to be made. Therefore, a full lift of the ban would depend on further trade negotiations progress, failing which we believe the ban could easily be reintroduced. Besides, we understand that some US companies continued selling equipment to Huawei despite the earlier ban by circumventing the restrictions. Nevertheless, sentiment-wise, the news could still be mildly positive for the Malaysian technology companies as it instils some hope for the end of the technology cold war, which have led many fabless companies/design houses to adopt a wait-and-see stance and hold back their investment/purchase decisions. On the trade diversion front, we believe Apple will continue assessing plans to move some manufacturing from China to Southeast Asia (including Malaysia) regardless of the ban lift, so as to avoid possible future trade conflicts as well as rising cost of manufacturing in China.

Decent functionality upgrade in upcoming flagship smartphone. In 3Q19, Apple is expected to launch a trio of flagship smartphone models as per its usual launch schedule in the past. While the models are unlikely to support 5G, the higher-end models are likely to feature a reverse wireless charging capability and a triple-camera system (thus allowing the device to participate in the camera race). As such, although the radio frequency (RF) content growth in the upcoming models may be limited, we believe sales volume should be able to sustain from last year given decent functionality upgrade, not to mention 3Q19 is usually much stronger QoQ in conjunction with the launch. Additionally, *GSMArena* reported that Apple may increase smartphone production modestly in anticipation that customers may shun purchasing Huawei smartphones amid fears of losing key applications/software services like Android in the future. Although the ban on Huawei is "somewhat" lifted (non-permanently), we reckon that some consumers will still be more inclined to switch to Samsung and Apple, just to be safe. This has positive implications for our local semiconductor players as their prospects are more closely tied to the Korean and North American smartphone players. As such, we believe the outlook for smartphone-exposed OSAT players will be relatively stable in 3Q19. Within our coverage, companies with meaningful smartphone exposure are MPI and UNISEM (33% and 26% of revenue in 1QCY19, respectively).

Worldwide Smartphone Sales to End Users by Vendor (m of units)

	Shipments (units)			Growth		Market Share		
Company	1Q19	4Q18	1Q18	QoQ	YoY	3Q18	2Q18	3Q17
Samsung	71.6	70.8	78.6	1.2%	-8.8%	19%	17%	20%
Huawei	58.4	60.4	40.4	-3.3%	44.5%	16%	15%	11%
Apple	44.6	64.5	54.1	-30.9%	-17.6%	12%	16%	14%
Oppo	29.6	31.6	28.2	-6.3%	5.1%	8%	8%	7%
Others	168.8	181.0	182.3	-6.8%	-7.4%	45%	44%	48%
Total	**373.0**	**408.4**	**383.5**	**-8.7%**	**-2.7%**	**100%**	**100%**	**100%**

Source: Gartner

5G to be the valuation kicker. We look forward to more commercial launches of 5G worldwide as it will not only drive the offtake of existing products (especially those relating to data infrastructure, radio frequency and sensors) but also lead to the creation of new/next-generation products and services. Previously, the process and timeline of 5G rollout were widely expected to be hindered by the US-China trade disputes, as the sourcing of telecommunication equipment and infrastructure could have gotten tricky amid Huawei ban. With the ban "somewhat" lifted, we see grounds for hope for 5G rollout to progress as planned, thus resuscitating the sentiment in the technology sector. The second 3GPP standard for 5G network (Release-16 or 5G Phase 2), which is due for release in March 2020, will further define specifications related to Vehicle-to-everything (V2X) communications, Local Area Network support in 5G and broader applications of Internet of Things (IoT) technologies. This paves the way for the development of connected/autonomous vehicles and smart/automated factories, which would in turn drive the offtake of RF and sensor devices in 2020. We believe this would augur well for MPI (OP; TP: RM12.10) and Unisem (UP; TP: RM2.15), which provide RF testing and sensor packaging solutions. Again, our UNDERPERFORM call on UNISEM is due to unattractive valuations.

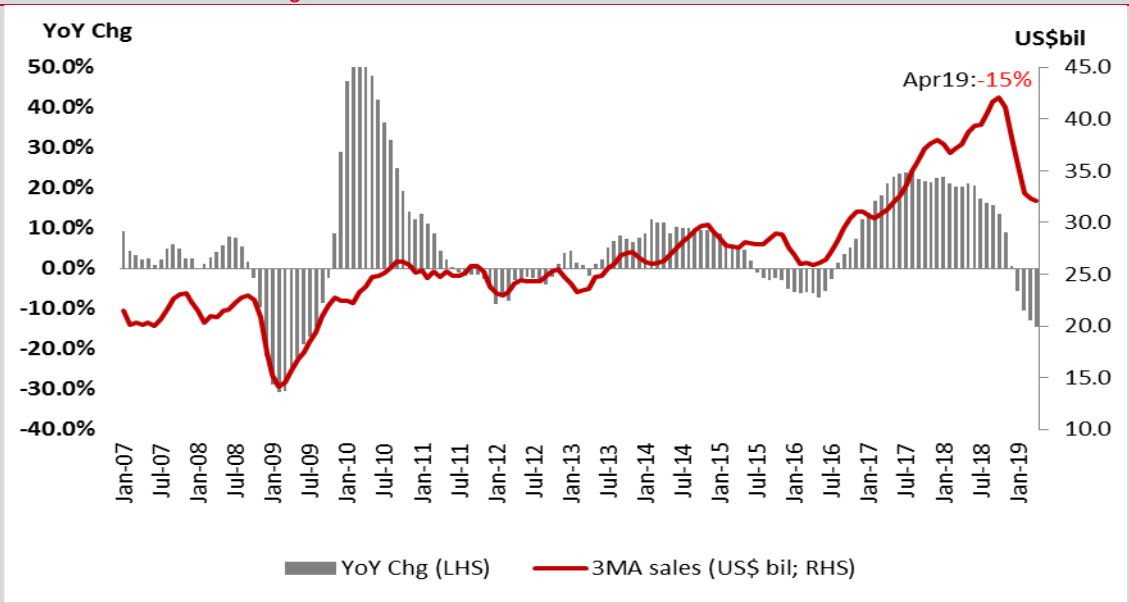
In the EMS space, prospects for SKPRES remain promising as it continues to see contracts driven by its major customers' shift to newer, evolutionary models. Additionally, the group's first PCBA line has commenced in April 2019, paving the way for more contracts given the key customer's emphasis for its contract manufacturers to be vertically integrated. Meanwhile, for PIE, its telecommunication, industrial printing, medical and raw cable customers should continue to see growth in sales volume in FY19. In addition, both the companies recently saw an influx of enquiries from companies that are looking to shift their supply chain out of China, which could translate into business opportunities in the near term. In fact, PIE has already secured a new contract for a telecommunication device which offers huge volume potential.

Upgrade sector stance to OVERWEIGHT (from NEUTRAL previously). Overall, with a potential turn of the tide in the technology sector (especially in the automotive segment), while valuations have also become more palatable, we reckon it is opportune to revisit the technology sector. We select (i) D&O (OP, TP: RM0.675) and (ii) KESM (OP, TP: RM8.70) as our top picks, both prime proxies for the automotive market recovery.

(i) **Upgrade D&O to OUTPERFORM from MARKET PERFORM with a higher target price of RM0.675** after rolling forward our valuation base from FY19E to FY20E (still based on 18.0x). We see D&O as a prime proxy for the potential recovery in the automotive market in 2H, amplified by its rising LED content in passenger vehicles and its augmenting market share. The introduction of smart LED (boosting ASP substantially) and growing focus on higher-margin exterior lightings also offer bright prospects and ensure sustainable long-term growth. These prospects are backed by its ongoing factory expansion plan, which could increase production capacity by as much as 3x. Having corrected 40-50% from the 52-week high of RM1.00 (on 4 October 2018), D&O's current share price (RM0.520 as of 28 June 2019) appears highly attractive, implying only 15.7x FY19E PER vs. its closest German peer's 23.4x.

(ii) **Upgrade KESM to OUTPERFORM from MARKET PERFORM with a higher target price of RM8.70** (from RM7.00) after pegging our valuation at a higher FY20E PER of 18.0x (mean) vs. 15.0x (-0.5SD) previously. We believe KESM's performance will pick up in 2H19 (1HFY20) along with the automotive market recovery, while its long-term prospects are also promising with rising semiconductor content in automobiles. Having corrected >60% from the 52-week high of RM18.20 (on 8 August 2018), KESM's current share price (RM7.02 as of 28 June 2019) appear highly attractive, implying only 15.1x vs. its historical mean of c.18.0x.

Global Semiconductor Sales and YoY growth



Source: SIA, Kenanga Research

WSTS Semiconductor Sales Forecasts by Product Type (Spring 2019 update)

	US$ bil				YoY %			
	2017	2018F	2019F	2020F	2017	2018F	2019F	2020F
Discrete Semiconductors	**21.7**	**24.1**	**24.5**	**25.7**	4.3	11.3	1.4	5.1
Optoelectronics	**34.8**	**38.0**	**37.5**	**39.7**	-3.8	9.2	-1.5	5.9
Sensors	**12.6**	**13.4**	**13.3**	**13.9**	22.7	6.2	-0.5	4.5
Integrated Circuits	**343.2**	**393.3**	**336.9**	**355.1**	0.8	14.6	-14.3	5.4
Analog	53.1	58.8	55.8	58.6	5.8	10.8	-5.0	5.0
Micro	63.9	67.2	66.5	69.1	-1.2	5.2	-1.1	4.0
Logic	102.2	109.3	104.9	110.5	0.8	6.9	-4.0	5.3
Memory	124.0	158.0	109.6	116.9	-0.6	27.4	-30.6	6.6
Total	**412.2**	**468.8**	**412.1**	**434.4**	**1.1**	**13.7**	**-12.1**	**5.4**

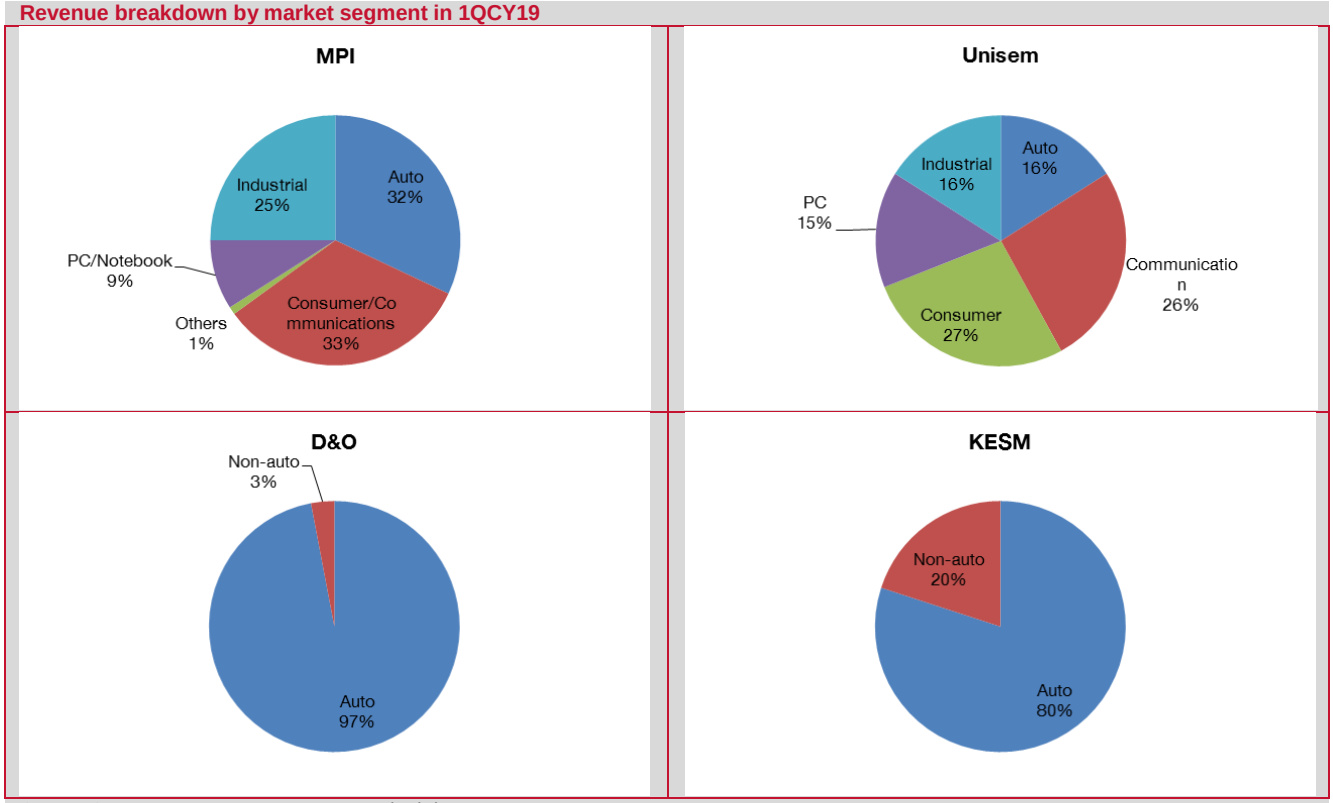
Source: WSTS (November 2018)

Worldwide Device Shipments by Device type, 2018-2021 (Millions of Units)

Device Type	Shipments (million of units)				YoY growth			
	2018	2019F	2020F	2021F	2018	2019F	2020F	2021F
Traditional PCs (Desk-Based and Notebook)	195	189	183	175	-7%	-3%	-4%	-4%
Ultramobile (Premium)	64	69	74	80	16%	7%	8%	7%
PC Market	**260**	**258**	**257**	**255**	**-3%**	**-1%**	**0%**	**-1%**
Ultramobiles (Tablets and Clamshells)	150	148	146	144	-7%	-1%	-1%	-1%
Computing Devices Market	**409**	**406**	**403**	**399**	**-4%**	**-1%**	**-1%**	**-1%**
Mobile Phones	1,812	1,802	1,825	1,798	-3%	-1%	1%	-1%
Total Devices Market	**2,221**	**2,209**	**2,228**	**2,197**	**-3%**	**-1%**	**1%**	**-1%**

Source: Gartner

Revenue breakdown by market segment in 1QCY19



Source: Company, Kenanga Investment Bank Bhd

Malaysian Technology Peers Comparison

Name	Last Price @ 21/6/19 (RM)	Market Cap (RM'm)	Shariah Compliant	Current FYE	Revenue Growth		Core Earnings Growth		PER (x) - Core Earnings			PBV (x)		ROE (%)	Net Div Yld (%)	Target Price (RM)	Rating
					1-Yr. Fwd.	2-Yr. Fwd.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	2-Yr. Fwd.	Hist.	1-Yr. Fwd.	1-Yr. Fwd.	1-Yr. Fwd.		
D&O GREEN TECHNOLOGIES BHD	0.560	620.9	Y	12/2019	3.7%	10.5%	8.6%	20.8%	17.2	16.9	15.0	2.0	2.0	11.6%	2.0%	0.675	OP
KESM INDUSTRIES BERHAD	7.00	301.1	N	07/2019	-9.8%	15.1%	-70.7%	74.3%	7.7	26.2	15.0	0.8	0.8	3.2%	2.6%	8.70	OP
MALAYSIAN PACIFIC INDUSTRIES BHD	9.21	1,831.8	N	06/2019	8.1%	5.3%	16.0%	5.8%	10.7	9.2	8.7	1.6	1.5	13.6%	3.4%	12.10	OP
P.I.E. INDUSTRIAL BERHAD	1.30	499.3	Y	12/2019	10.4%	6.2%	1.4%	13.0%	11.8	11.6	10.3	1.2	1.1	9.9%	3.8%	1.55	OP
SKP RESOURCES BHD	1.31	1,637.7	Y	03/2020	28.5%	15.2%	30.4%	13.3%	16.9	13.0	11.4	2.8	2.5	20.3%	3.9%	1.40	OP
UNISEM (M) BERHAD	2.55	1,854.1	Y	12/2019	1.7%	8.0%	3.6%	29.5%	19.4	18.9	14.6	1.3	1.3	6.8%	3.5%	2.15	UP

Source: Kenanga Research

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Stock Ratings are defined as follows:

Stock Recommendations

OUTPERFORM	: A particular stock's Expected Total Return is MORE than 10%
MARKET PERFORM	: A particular stock's Expected Total Return is WITHIN the range of -5% to 10%
UNDERPERFORM	: A particular stock's Expected Total Return is LESS than -5%

Sector Recommendations***

OVERWEIGHT	: A particular sector's Expected Total Return is MORE than 10%
NEUTRAL	: A particular sector's Expected Total Return is WITHIN the range of -5% to 10%
UNDERWEIGHT	: A particular sector's Expected Total Return is LESS than -5%

******Sector recommendations are defined based on market capitalisation weighted average expected total return for stocks under our coverage.***

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